Charges to FRAC

Clearing Members' Management of Risks to CCP Exposures

1. **What methods and metrics are financial market participants (especially clearing members) using to analyze their exposures to CCPs?**

2. **Are clearing member risk management practices regarding their exposures to CCPs adequate?**

Nonbank Mortgage Servicing and Origination

3. **What methods and metrics are financial market participants using to analyze potential vulnerabilities associated with the increasing share of nonbanks originating and servicing mortgages?**

4. **To what extent could distress among nonbank mortgage companies transmit risk to the financial system?**

Additional information on these charges:

TOPIC: Clearing Members' Management of Risks to CCP Exposures

SUMMARY

The OFR is requesting that the Financial Research Advisory Committee (FRAC) consider how clearing members assess and manage their exposures to CCPs.

BACKGROUND

Since the 2007-09 financial crisis, CCPs have assumed an increasingly important role in markets where trading had previously been bilateral. Central clearing has several advantages: (1) greater transparency and standardization of contracts, (2) greater potential for the netting of positions, and (3) a shortening of the length of intermediation chains, which reduces the potential for contagion. The principal disadvantage of the shift to central clearing is to concentrate risk by creating central counterparties whose default could have widespread consequences. As a result, the Financial Stability Oversight Council (FSOC) has designated five major central counterparty operators as systemically important. If one or more of these CCPs experienced significant member failures that exhausted CCP waterfall resources, there could be severe disruptions to the financial system. The

adequacy of clearing members' and CCPs' risk management practices is thus a critical question for the FSOC and its members.

This raises two important concerns for clearing members. First, how can, and do, market participants analyze their exposures to CCPs? Second, are the risk management practices of clearing members adequate for their exposures to CCPs?

QUESTIONS FOR CONSIDERATION

Below are some questions of interest that could be among those considered in responding to the charge:

1. Major CCPs publicly disclosure their risks quarterly using standards developed jointly by the Bank for International Settlements' Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions. These disclosures offer market participants and regulators insights into several CCP risks. These disclosures include measures such as member concentration, margin sizing, and the largest margin calls. They also cover estimated losses under stress, including expected losses beyond initial margin resulting from a scenario in which their first and second largest members default.
    a. What, if any, additional information disclosures do clearing members receive that are used in their own assessments of CCP risk exposure?
    b. If one were to consider additional CCP metrics or risk management plans to be disclosed, with the objective of providing further insight into a CCP's risks, what would clearing members want?

2. A clearing member's exposure to a CCP includes both its positions and its participation in the CCP's default waterfall, which protects against payment defaults by *other* members. The first line of defense in the waterfall is the initial margin posted by each member; additional defenses are provided by the CCP's skin-in-the-game and guarantee fund. If these resources are exhausted, the CCP can assess its members. The CCP can also reduce its payments through Variation Margin Gains Haircutting. How do current standards for setting the amount of a member's initial margin as a function of its positions, liquidity, and other factors affect the risk of the members? How often is initial margin exceeded in practice?

3. The current standard for sizing the default fund is that it should be sufficient to cover payment shortfalls by the two largest clearing members under "extreme but plausible" market conditions (the Cover 2 standard). How do clearing members use theoretical and/or statistical models to self-assess extreme but plausible conditions?

4. Most CCPs have capital contributions, or skin-in-the-game, that is very small relative to the size of their default funds in the United States. How important is the size of a CCP's skin-in-the-game in a clearing member's decision to join a CCP? Do clearing members feel the level of risk-sharing on behalf of CCPs is appropriately sized?

5. CCPs typically can assess their members if their waterfall resources are exhausted in order to fulfill payment obligations. Do clearing members believe that assessments are both a

useful and 'realistic' end-of-waterfall mechanism for dealing with short-term liquidity risks or longer term losses? Do clearing members' risk management strategies include these assessments?

6. Major market participants manage cleared positions with multiple CCPs across multiple jurisdictions. How do clearing members who operate at this scale manage payments and collateral? Can payments and collateral easily be moved to meet sudden demand shocks? Additionally, are there cross-border or cross-CCP risks that clearing members particularly risk manage for?

7. Clearing members are also potentially exposed to a CCP's operational and cyber risks, which could result in failure of the CCP to pay its members. Who bears the responsibility for costs or losses that might occur in such a scenario? What information and metrics regarding these risks do CCPs provide to members and regulators?

TOPIC: Nonbank Mortgage Servicing and Origination

SUMMARY

The OFR is requesting the Financial Research Advisory Committee (FRAC) to consider questions and provide feedback, with supporting analysis, regarding vulnerabilities that may arise from the increasing share of residential mortgages originated and serviced by nonbanks.

BACKGROUND

The share of residential mortgages originated and serviced by nonbanks has increased significantly over the past decade. Nonbank mortgage companies play an important part in the extension of credit to certain key market segments, such as borrowers requiring Federal Housing Administration (FHA) insurance, and servicing mortgages held in Enterprise and Ginnie Mae mortgage-backed securities.

Servicers of these mortgages often have the obligation to make payments to investors even if the borrower does not make mortgage payments. Though their business models vary, most nonbanks do not have a stable funding base, and instead rely heavily on short-term funding for both originations and servicing advances. Nonbanks often obtain liquidity from warehouse lines provided by banks, and these lines can be a significant portion of nonbank liabilities. In times of significant stress, if delinquency rates rise or nonbanks otherwise experience solvency or liquidity strains, warehouse lenders may face strong incentives to cancel lines and seize collateral. An important question, then is the extent to which distress among nonbank mortgage companies could transmit risk to the financial system.

QUESTIONS FOR CONSIDERATION

Below are some questions of interest that could be among those considered in responding to the charge:

1. The 2019 FSOC annual report acknowledge that there are fragilities in nonbank mortgage origination and servicing that could transmit risk to the financial system, including fewer

resources to absorb adverse shocks and more dependence on short-term funding. Are there steps that market participants have been taking to mitigate some of these risks?

2. How have market participants viewed recent reforms proposed by FHFA and Ginnie Mae?

3. The share of residential mortgages originated and serviced by nonbanks has increased significantly over the past decade. What has driven this change? Are there regulatory requirements or supervisory/enforcement actions that have contributed to the market's evolution? How will recent reforms by FHA, HUD, and DOJ influence the composition of lending in the FHA program?

4. What debt covenant requirements or other metrics do market participants monitor as predictors of future stress for mortgage originators and servicers?

5. How did warehouse lending during the crisis differ for conventional and FHA lending? Was this a source of risk? How would warehouse lending occur today if there was a similar stress event?

6. While the contours of the next downturn are unknown, how do you think warehouse lenders would respond if some nonbank servicers are delinquent on their credit lines? Would there be a rush to withdraw credit lines, modify terms, or are nonbanks sufficiently distinct that the issues at some would not affect your opinion of others?